

October 18, 2000

LETTER 1308

THE PICTURE: We're in a primary bear market. You read it here first, you read it here second and third, you read it here ever since the Dow Theory bear market signal of September 23, 1999.

On October 9 my Primary Trend Index turned bearish, confirming the overall bear trend.

There are three kinds of stock market analysts. Actually, there are only two legitimate kinds, but I'll talk about the third kind first. The third kind is the imposter, the person who decides that talking about the stock market is a good (or glamorous) way to make a living. Since the public doesn't know the difference between sincere, authentic market analysis and utter nonsense, this third kind of "analyst" writes nonsense books ("Dow 35,000") or lands on some TV or radio program, and presto, we have the professional fakir, the great "stock market soothsayer."

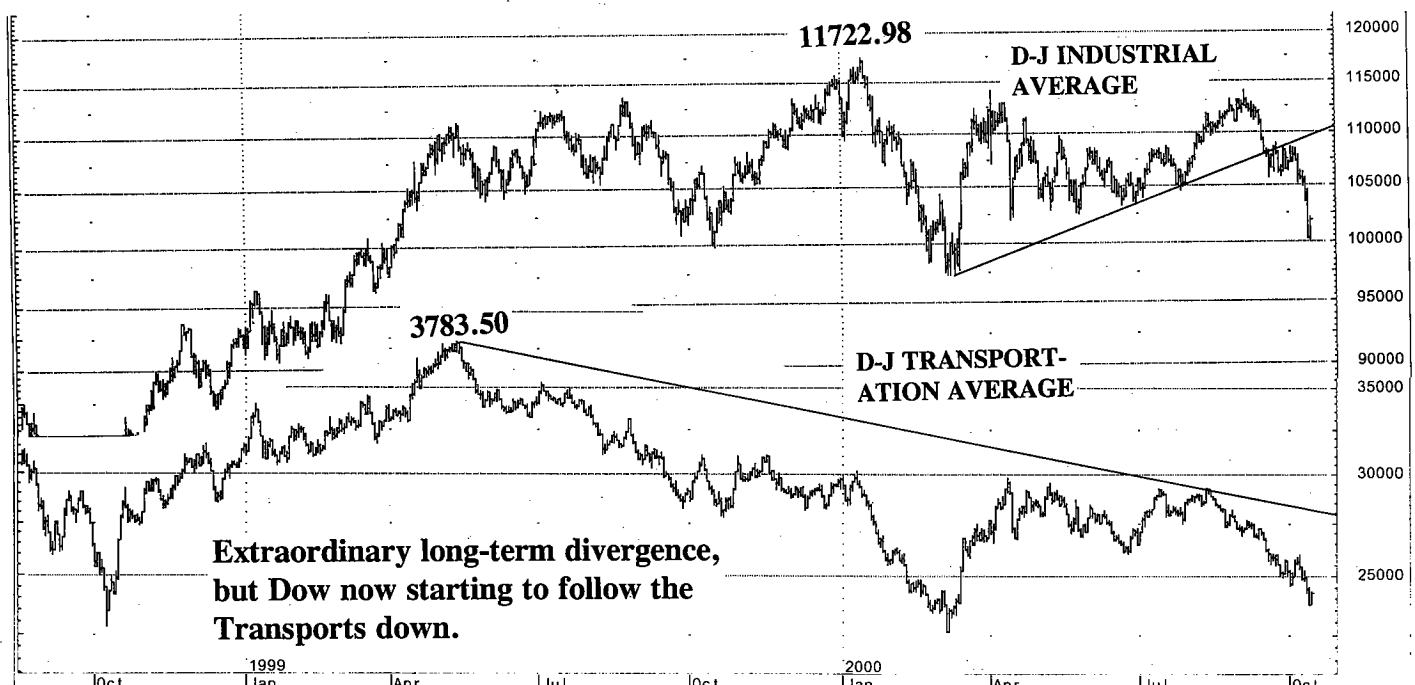
Often this person becomes a stock market celebrity. You can read about him or her in that fascinating new book, "The Fortune Tellers, Inside Wall Street's Game of Money, Media and Manipulations", by Howard Kurtz. I recommend this book highly.

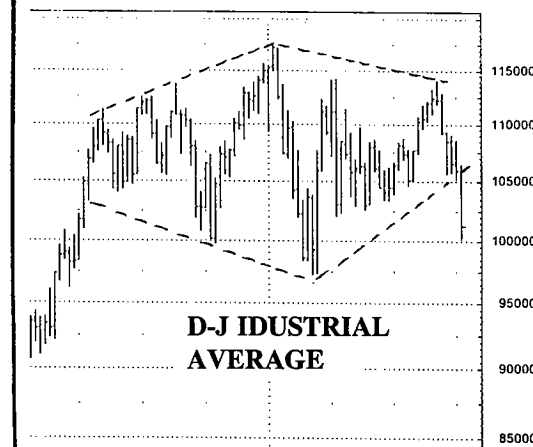
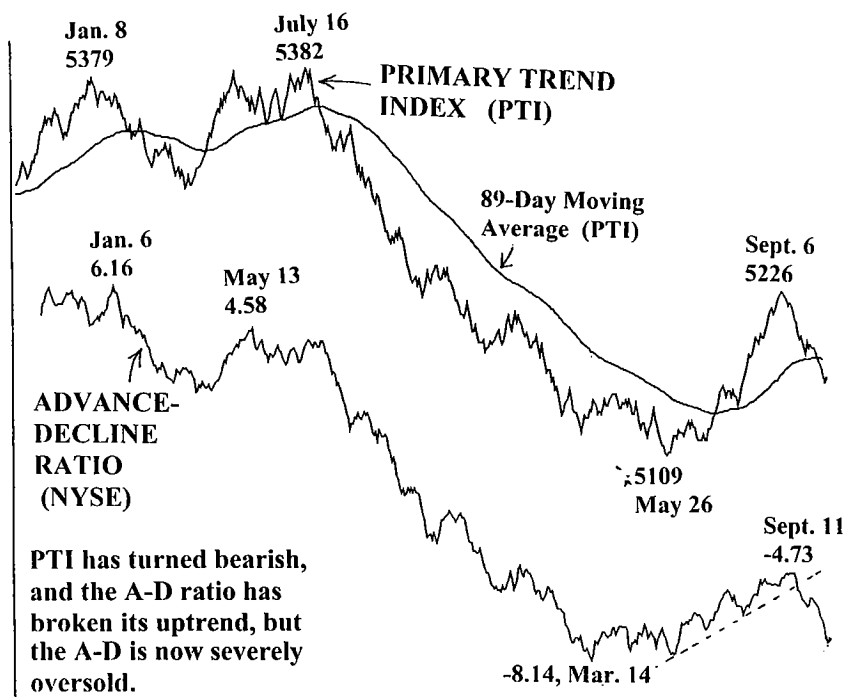
Sept 29, DJIA 10650.92; PTI 5186; A-D Ratio -5.68
Oct 6, DJIA 10594.54; PTI 5180; A-D Ratio -6.38
Oct 13, DJIA 10192.18; PTI 5169; A-D Ratio - 7.29
*Dow Yield: 1.73%; *Dow Price/Earnings: 19.0
*Dow Times Book Value: 6.22
*Percentage of Undervalued Blue-chips: 16%
*Gold 34-day MA: 276.50

The second kind of stock market analyst is the one who usually works for a brokerage house. Most of these people are sincere, some are very good, some are fair, and some are incompetent. The problem with these analysts is that they must always pick stocks for buying and they must always be bullish. Most of the second kind of analysts deal with individual stocks rather than the general market and the "big picture." They work hard and they are always under pressure.

The third kind of analyst is the independent who writes about the stock market as a whole, the big picture, plus in most cases individual stocks, investing, theory, whatever and where ever their own interests lie.

The people in this third group are the people who I tend to read and follow. They are the ones who interest me the most. Some are very good, some are fair, some are





Diamonds are not an investors's best friend. Here we see the giant "diamond" pattern in the Dow; a diamond is simply a variation of a 'head-and-shoulders' top pattern. Last week the right shoulder of the diamond broke down, but to complete the pattern the Dow would have to break below the March low of 9796.03. (This is a weekly chart).

hopeless. But most of them are died-in-the-wool stock market fanatics, and I respect them.

Blushingly, I put myself in the third class of analysts. But what gives me the right to call myself an analyst? What makes me an "analyst?" Really, nothing except years of study and experience. Plus the willingness to deal with the market, write about the market, learn about the market, struggle with the market. But above all, to belong to this third class you must have an obsessive fascination with the stock market.

I think to succeed in this business you need intuition, brains, artistry, a healthy skepticism, the ability to project your thoughts, and an **incurable curiosity** about the stock market and the world. You need all of these things.

I guess my own curiosity grew out of my experiences during the Great Depression and during World War II and its aftermath. I saw events turn from bad to horror to relief and thence to elation. I wanted to know why, how -- and whether it all made sense.

I intuitively knew that the various changes had something to do with the stock market or at least that the stock market somehow provided hints about the future. The more I studied the history of the stock market, the more fascinated I became with Wall Street. I caught the stock market "bug" around 1947, and it's still with me -- maybe stronger today than ever.

I've always envisioned the stock market as a living organism, an ever-changing animal. The animal today is a

great, brilliant, sneaky, diabolical bear. The bear is cunning, ruthless, without emotions, and without pity.

At this point, I think the bear has accomplished his first goal. That mission is to lock the largest number of people into the stock market -- **lock them in with losses**. I believe, based on my talks with many people, that the majority of Americans are now locked into this bear market with losses.

The next step for the bear -- is to take the market down while keeping this "losing majority" in the market, keeping them "happy, hoping and above all holding." How can the bear accomplish this feat? He'll do it with the help of a "cheering section" made of amateur TV and newspaper reporters and perma-bull brokerage house analysts.

And, of course, there is the investor's own reluctance to "take a loss." So the investor listens to the reporters -- the investor is only human -- and he hears what he wants to hear.

Of course, there's one other phenomenon that I should mention. It's the average person's inability to envision or accept CHANGE. The evolution from a primary bull market to a primary bear market entails massive change. White becomes black, and day becomes night. This is more than the average investor can accept or deal with.

Furthermore, there's the natural and understandable reluctance of the average person to face "bad times." Bad times entail pain, and people will do anything they can to avoid pain, including even thinking rationally about it.

This month, the month of October, is often called the "bear killer" month. The reason is because so many costly market declines have started in the second half of the year and ended in October. In fact, I've heard many people in recent weeks talk about this month of October as the time when they're going to "buy stocks for the coming big advance."

So will this October end the bear market? It could, but my instinct and my studies say that it won't end the bear market. My instinct says that this year's "October surprise" is that this October will not end the bear market at all - that there's a lot more of this bear market ahead of us.

If this is a primary bear market, if this is the bear market that corrects the excesses of the preceding bull market, then we're going to see stocks return to "known values." Known values means a return to classic price/earnings ratios and a return to classic yields. Could the Dow ever come back to 10 or 12 times earnings and a yield of 6% or better? Is that possible? Will we ever see it? The answer, I believe, is yes.

And if it happens it will obviously involve massive changes. There will be changes that will toss the average investor's expectations into the garbage can. The changes will be massive and almost unthinkable today. But they will occur. And those changes are what make this whole stock market study so fascinating. You might remember that old adage, "the only thing constant in this world is change."

INVESTMENT POSITION:

The bear remains in the box. Why? Because we're in a bear market, no other reason.



In a bear market the idea is to avoid losses, or if you must take losses the idea is to hold those losses to a minimum. I'll be honest, I don't know the ideal place to be in this bear market. So I'm going to guess - I'm guessing that the best place to be is in the best grade paper. That would certainly include the premium paper -- government paper.

Which government? I wish I knew the ultimate answer to that one, but US Treasury bills, notes and bonds carry the full faith and credit of the United States. That should be good enough. When you buy US Treasury paper you only have to worry about three things: (1) inflation, but in a big bear market that shouldn't be a worry; (2) the dollar, and this could be a worry, but I don't know how to get around it; (3) the actual market price of the bill, note or bond. But if you want to eliminate that worry, you buy bills or two year notes. If you think the Fed will knock interest rates way down in a recession, you go out further, maybe even buy 20 or 30 year T-bonds. Or, of course, you can buy a combination of bills and notes and bonds.

Or you can buy top-grade munis, preferably GOs or general obligation bonds from your own state. Of course, if you think your state can't hold together in a big bear market, don't buy their debt. Personally, I'd be very surprised if any state couldn't make good on its own debt. I sure hope California can (hey, we've got Silicon Valley and Beverly Hills, haven't we)?

As for stocks, 85% of all stocks will go down in a primary bear market. Consequently, the odds are low that the stocks that you now hold will beat the bear. Enough said.

NOTES & QUOTES: The polls on the presidency, I feel, are useless. The latest seems to make it a draw with an error of 3-4%. What good is that? A better thought is this: Ronald Reagan, George Bush and Bill Clinton were all lefties (so is Richard Russell, for that matter). Al Gore is also a lefty but George Jr. is a rightie. So there's the info that should tell us who the winner is. But does it? After all, aren't lefties in the driver's seat? But wait, what are the odds of a fourth lefty making it? Russell Conclusion: I don't think another lefty can make it (just kidding).

More important - historically, a rotten stock market and a slowing economy favors the challenger, not the incumbent. The way things are going, I would say that history now favors Bush.

Coffee futures have plunged to an eight-year low. I remember when coffee was a nickel a cup at restaurants. Then coffee futures surged, and restaurants went to a dime a cup. Now with coffee plunging, is anyone dropping the price for a cup of coffee? I haven't heard of anyone doing it yet. A sign of the times. When times get tough, restaurants and everyone else get competitive. Hasn't happened, yet. But I understand that pricing power (ability to raise prices) in the stores is almost non-existent.

The Aussie dollar hit a record low last week of .537. One problem, the Australian central bank refuses to raise rates despite Aussie inflation rate of 3.2%.

From the *Fortune* magazine "Business Confidence Index:" Financial executives from 1000 companies were asked, "Are you confident or worried about sustaining US economic growth over the next two years?" In August 72% of those asked were confident. In September the percentage dropped to 64%.

Fortune also runs what they call their "Dot-Com Death Watch." Since January *Fortune* counts 77 dot-coms that have died. Says *Fortune*, "At this rate, the Death Watch will clear 100 by the end of the year."

A subscriber e-mails this to me: "I know you don't subscribe to AOL, but - when you log onto the system a news page comes up. All summer long when stock prices

were rallying, AOL would post market articles and prices. I have not seen a thing in weeks!! These guys are as bad as CNBC, a virtual conspiracy of silence."

* *
SEC Chairman Arthur Levitt is in what he calls "the fight of my life." What fight? The fight to end big accounting firms from acting as both accounting and consulting firms for the same company, a clear conflict of interest in Levitt's view (a hypothetical example, an accountant doing an audit might offer unneeded and unsolicited consulting services). The big five accounting firms say this isn't happening and lacking proof, the government is simply meddling needlessly.

* *
I just finished "The Fortune Tellers" by Howard Kurtz. If this book doesn't render you totally cynical about the TV stock market stations, the celebrity journalists, the brokerage house analysts and all the hype and manipulation that are a part and parcel of this market, I don't know what will. I recommend this new book highly - it makes fascinating and educational reading.

* *
Faye bought an Olympus digital camera with a printer and all the accoutrements. The camera takes great pictures and you can take about 65 high quality pictures with one load. Downloading the driver gave Faye a lot of trouble, but once she got it going, all was well. The pictures are of fine quality and the little printer churns them out (8 1/2 by 11 inches) in full color. The pics can also be sent via e-mail to your loved ones -- or even to your enemies.

* *
I'm still receiving a lot of questions from new subscribers regarding the **PTI** and the **A-D ratio**. So here goes --- again:

The **PTI** is a proprietary composite of 8 items, each one dealing strictly with **market action**. So no subjective considerations, no guessing, no adjusting -- these 8 items are based on actual daily market action. I've been running the **PTI** daily since 1971. The **PTI** monitors the sub-structure of the NYSE. I liken it to the water in a bathtub. The Nasdaq (the soap) can bounce up and down all it wants, but it's the level of the water in the bathtub that tells us what the great primary trend is doing. The **PTI** is the level of the water in the tub.

The **advance-decline ratio** monitors the direction of the majority of stocks on the NYSE. Each day I take the difference between all the issues that advanced and all the issues that declined. To adjust for the increased number of issues that appear on the NYSE over the years, I divide the daily differential by the issues traded each day. If more issues were up than down, I add the day's figure to the preceding total. If more issues were down for the day, I subtract from the previous day's total. The total can be started anywhere -- at 10,000, 50,000, a million.

The **Big Money Breadth Index (BBI)** is an index I "invented." To my knowledge, nobody else runs it. It's an advance-decline of the ten largest-cap stocks in the S&P 500.

I think it's a valuable index since the direction of the majority of these ten giants has to be important in the broad market picture. It's hard to envision a bull market without the **BBI** trending generally higher. It's hard to conceive of a bear market without the **BBI** trending generally lower.

* *
The amount of money that is coming into stocks from venture capitalists is still mind-boggling -- this year the new money is heading for \$110 billion. The incredible sum of money flowing into new companies has been one of the mainstays of this market. But as profits get squeezed (and they are getting squeezed) the odds are that this money is going to dry up and the cycle is going to be reversed. This could result in a further tech bust, and (this is hard to believe) a big break in the price of houses in Silicon Valley). So far, in the face of a collapse in many dot-coms and a crash in many tech stocks, the money continues to come in from venture capitalists. But how long will this dollar-stream continue? That's a critical question and it probably won't be answered this year.

* *
Sign of the Times Dept: In the holiday catalogue of Neiman Marcus they offered a silver-and-black 2002 Neiman Marcus special Thunderbird (buyers to take delivery next summer). Even Neiman was stunned when they sold the 200 limited edition T-birds (price \$41,995 a copy) out in two hours and 15 minutes.

* *
With the various mutual and pension funds loaded with certain stocks such as GE, CSCO, JDSU, AMAT, I believe there's a concerted effort to try to keep these stocks above critical breaking points. For instance, one KEY stock is GE with critical support at 55. Watch and see if GE closes below 55. So far, it hasn't (although it's been below 55 intra-day). Critical support for AOL comes in at 50. Critical support for CSCO comes in at 50.

THE MEAN: What's the most frightening prospect facing the stock market? It isn't expensive oil, it isn't a falling dollar, it isn't declining profits, it isn't even a crash.

No, the most frightening thing about the stock market is a four-word phrase. The phrase is "**RETURN TO THE MEAN.**"

Why is a return to the mean so frightening? First, because sooner or later the odds say it's going to happen. And secondly, because a return to the mean would imply a bear market or a "no gain" market over a period of years. Let's check some statistics.

The mean annual gain (not including dividends) for the Dow over the last 100 years was 5.3%.

But the annualized gains for the Dow over the last five years has been 24.6%. Can that continue? Sure it could, but each new year makes it less likely. In fact, the odds

increase through time that the Dow will return to "normal" or back to the mean. But which mean over which length of time?

Let's check the mean over four different lengths of time.

To bring the Dow back to the 100 year mean (5.3% a year) it would take a one-year drop of 54.6% or no Dow gains at all for the next 16.3 years.

Now instead of 100 years, let's take the mean over the last 50 years. Over the last 50 years the Dow has gained 8.4% a year. To bring the Dow back to this mean, it would take a one-year drop of 45.8%, or no market gain for the next 8.6 years.

Instead of 50 years, let's take the last 20 years. Over the last 20 years the Dow has gained 14.0% a year. To bring the Dow to this mean, it would take a drop of 26.9% or no gain at all for the next 3.4 years.

All right, let's take the last 10 years. Over the last ten years the Dow has gained an average of 21.4% a year. To bring the Dow back to that mean, the Dow would have to lose 21.4% in a single year or suffer no gains at all for 2.7 years.

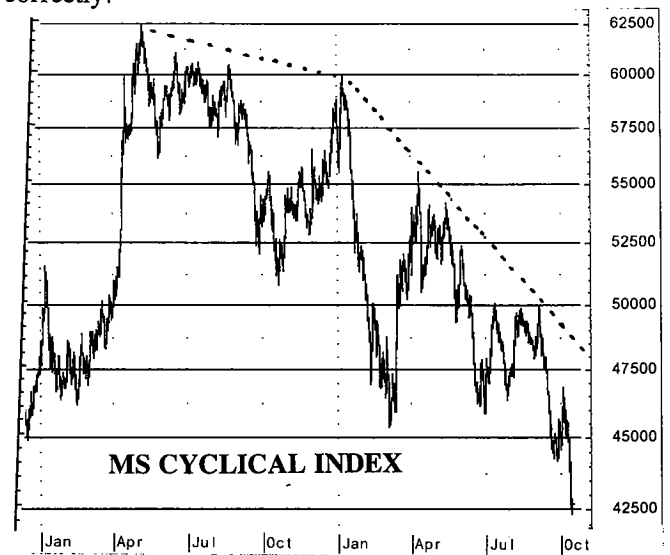
Can the Dow beat the mean gain of the last 100 years? The last 50 years? The last 20 years? How about the last 10 years? Or will the Dow never return to the mean of even the last 10 years?

It's your guess, and you're entitled to it. But one thing I'm convinced of. One way or another, the Dow is going to come back to one of the above rates of growth. It's simply a matter of time.

Below is a "name" analyst who obviously doesn't subscribe to the "reverting to the mean" concept. But if you want to make a name for yourself as an analyst, just come up with something sensational, something people want to hear. The truth is that nobody on God's green earth knows where the market will be in ten years, in five years, in a year.

But people believe what they want to believe. And there are now a huge number of investors with losing portfolios who want to believe in "Dow 20,000." There's only one expert

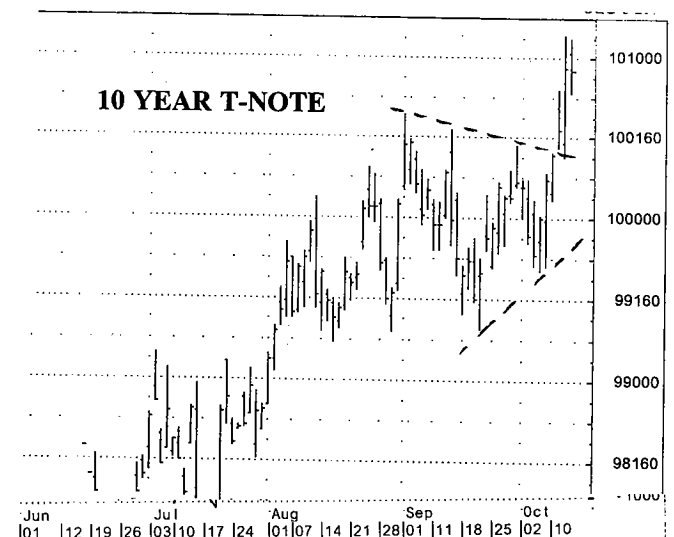
on the stock market, and that's the market itself. My job – to try to interpret what the market is saying and interpret it correctly.



STORY: The stock market is always telling a story – if only we could read that story. Here are a few charts that I think will help us unravel the story that is now being spelled out.

First, this is the Morgan Stanley Cyclical Index. It doesn't take much interpretation. This Index is telling us that we are facing a cyclical downturn and that downturn has to do with the stocks that are the backbone of the economy.

I know that the general opinion is that the US economy is booming. That's yesterday and today, which will be history tomorrow. The stock market isn't interested in history, it's interested in discounting the future. The Cyclical Index is telling us that late fall and the Christmas season is going to lose momentum. By winter or spring the economy could be in trouble.



Superbull Sees Dow 20,000 Coming

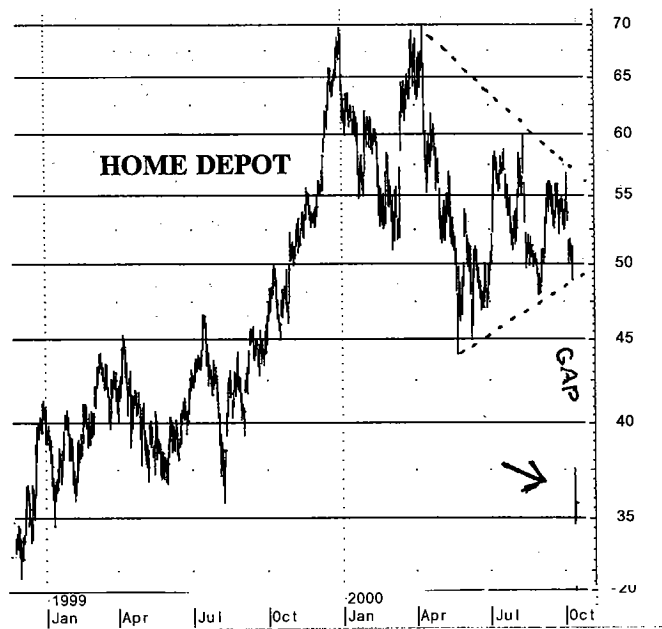
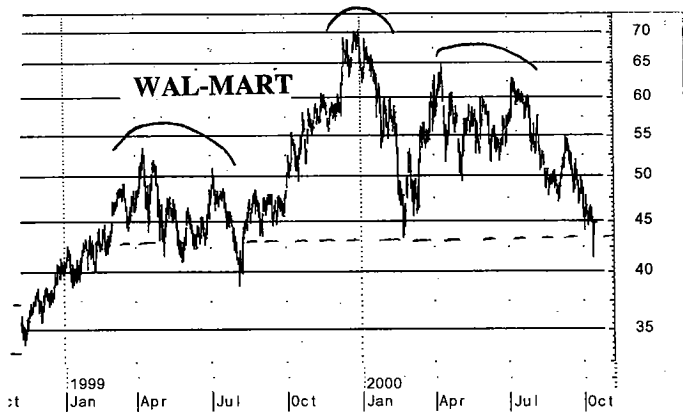
Ralph Armstrong, who Louis Rukeyser calls "the high priest of technical market analysis," risked his career as Prudential Securities' leading technical analyst by predicting Dow 20,000 while it was still in the low 4,000s. His projection – considered

of Dow 22,354.67 by the year 2011. It gives enough leeway for the stock market to have a couple of normally flat years and even a few antiprecipitous bear markets before reaching this lofty goal.

A. At that time I realized that several key economic and political factors were running together in such a way that could create an environment that would support a multi-year stock market rise. After checking my facts, and checking them again, I predicted

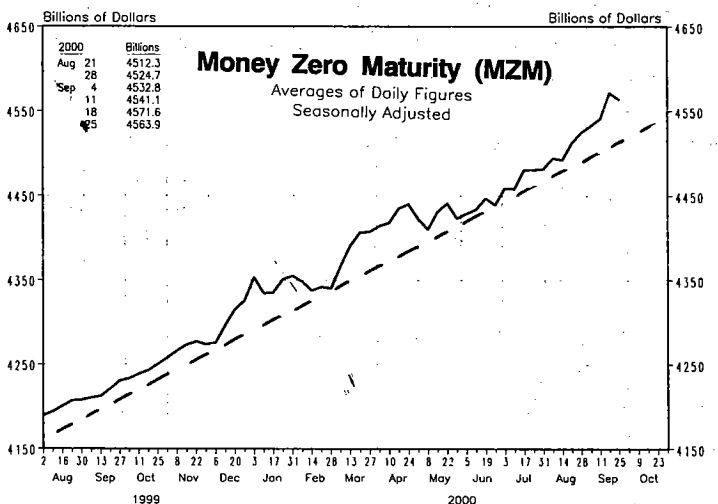
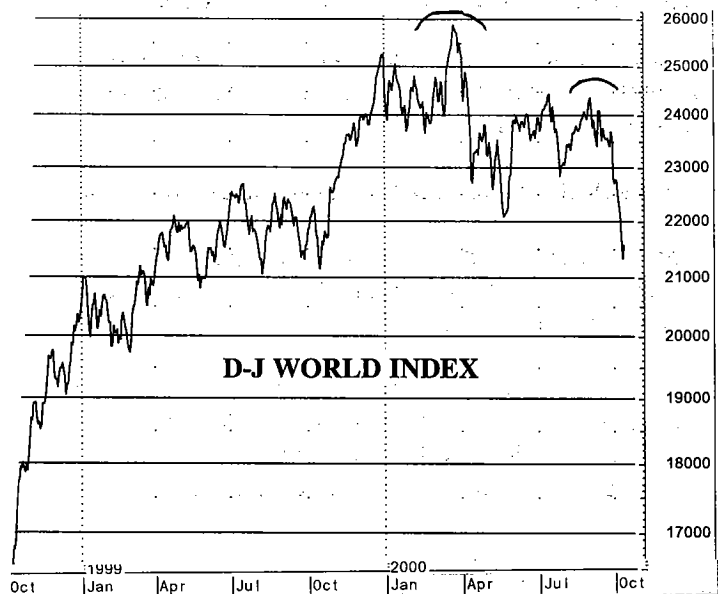
The next chart shows the bellwether 10 year T-Note (the Dec. futures). Here we see a stubborn uptrend and then a break-out last Thursday from a triangle pattern. Thus, the bonds are saying that stocks and the economy are in a bearish mode, that interest rates will be heading lower, and that the place to be is in bonds.

Two stocks that I want to show are mighty Wal-Mart and the tiger of home building and shopping, Home Depot. Both of these very important retail stocks are in steep bear market declines. Both gapped down on October 12, with HD crashing down over 13 points.



The next thing I want to show is the Dow Jones World Stock Index. This Index has formed a huge top, then last week it broke sharply below its May low. This suggests to me that a world economic slowdown is on the horizon. I really hate to see what this Index is doing. It doesn't bode well for a world that is facing possible war in the Mid-East. Economic trouble can precede political and social trouble. The next US president is not going to have a picnic.

NEXT MAILING: November 8, 2000



"What me worry?" Yes, the Fed must be worried. This is a chart (courtesy of the St. Louis Fed) of the MZM money supply, a proxy for cash. The Fed has been pumping up MZM at an annualized rate of over 11%. Do you ever wonder why the dollar has lost over 90% of its value since the 1940s? Turn to the Fed, our modern "engine of inflation."

GOLD: There isn't a lot I can say about gold here, so I'll be brief and keep it very simple. The 34-day moving average for Dec. gold stands at 276.50. Above that is the 144-day MA for Dec. gold, which stands at 284.30. Forget the 144-day MA -- gold's first job is simply to rally above 276.50. If it can do that, then the next target for Dec. gold would be the important "double top" at 282.50. That's the long and short of it. There's little more to say.

LATE NOTES: The "follow-up rally" in today's market was notable in that leading tech stocks sold off and breadth was just barely positive (remember, breadth was sub-standard on Friday's big surge). Thus, the rally has been very selective with big money going back into the more staid blue chip stocks, most of which have already been battered (this Late Notes was written only one hour after the opening Monday, so I don't know how the market closed).